No. 14,374

United States Court of Appeals

For the Ninth Circuit

S. NICHOLAS JACOBS and DOLORES I. JACOBS, *Petitioners,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	}

PETITIONERS' OPENING BRIEF.

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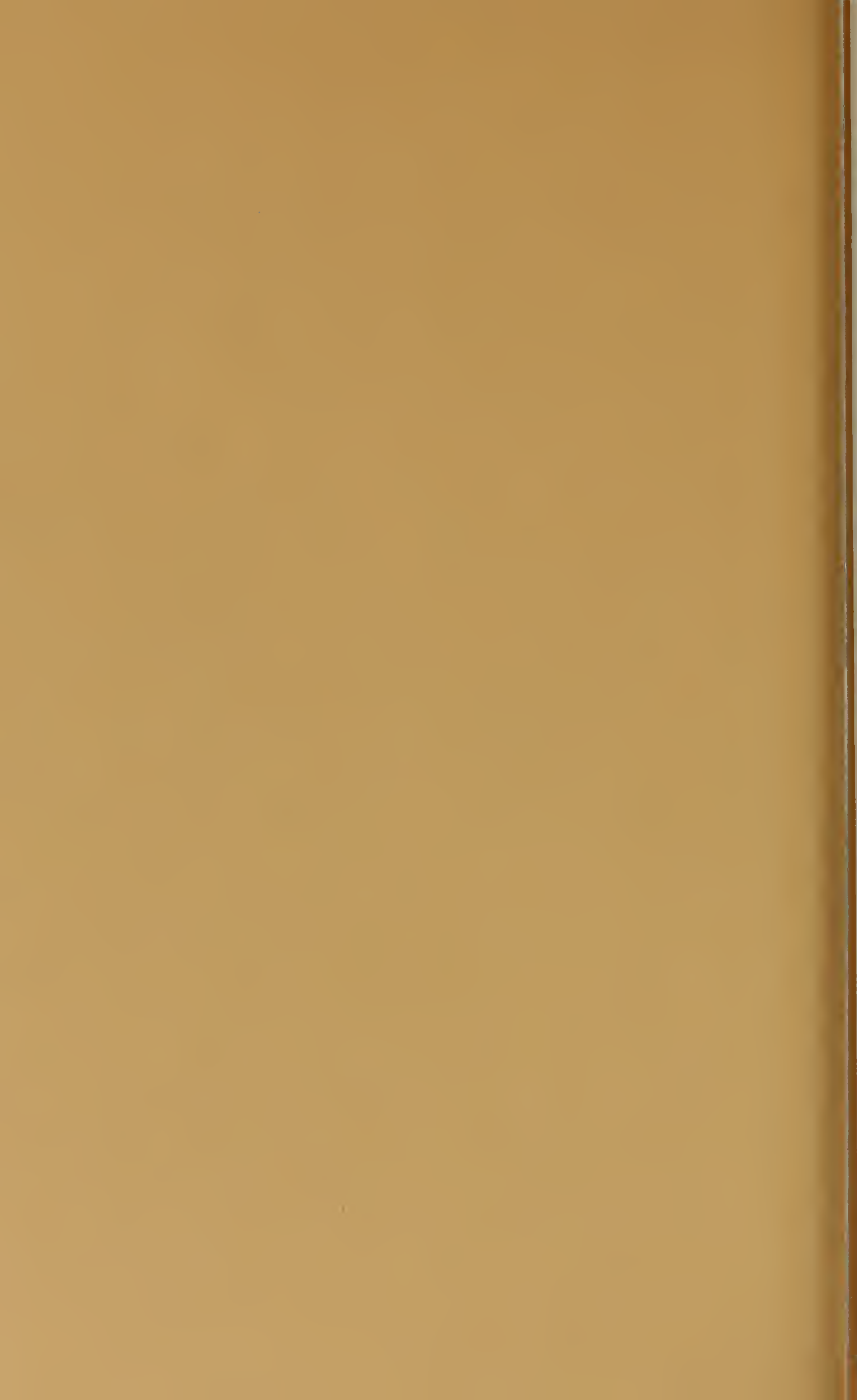

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No. 14,374

United States Court of Appeals
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S. NICHOLAS JACOBS and DOLORES I. JACOBS,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONERS' OPENING BRIEF.

STATEMENT OF JURISDICTION.

The petitioners and the appellants (hereinafter usually referred to as "taxpayers"[1]) were residents of the City and County of San Francisco, State of California, at all times material or relevant to these proceedings and filed their joint return for the period here involved with the Collector for the First District of California. (Tr. p. 5.)

The respondent is the duly appointed, qualified and acting Commissioner of Internal Revenue of the

[1]Dr. S. Nicholas Jacobs, one of the taxpayers, was the owner of the lands involved in these proceedings and is hereinafter usually referred to as "taxpayer."

United States, holding his office by virtue of the laws of the United States and is hereinafter usually referred to as respondent.

Respondent determined a deficiency against taxpayers for the calendar year 1948 in the amount of $42,109.63 and on or after February 6, 1952, sent to the taxpayers by registered mail, notice of said deficiency. (Tr. pp. 13 to 19.)

As authorized by Section[2] 272(a)(1) of the Internal Revenue Code and within 90 days of the mailing of such notice of such deficiency and on May 5, 1952, petitioners filed their petition for the redetermination of said deficiency with the Tax Court of the United States (herein usually called the "Tax Court"), being Docket No. 40649. (Tr. pp. 5 to 12.) Thereafter respondent filed his answer thereto. (Tr. pp. 20 to 22.)

The case was in due course submitted to the Tax Court upon a stipulation of facts and evidence oral and documentary. On October 30, 1953, the Tax Court promulgated its memorandum findings of fact and opinion in said proceeding. (Tr. pp. 89 to 100.) On February 4, 1954, the Tax Court rendered its decision, judgment and order of redetermination wherein and whereby it ordered and decided that there was a deficiency in the amount of $41,370.43 in the taxpayers' income tax for the calendar year 1948. (Tr. p. 103.)

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[2]Unless otherwise specifically stated all references to Sections herein refer to the Internal Revenue Code as amended which said Code is Title 26 of the United States Code. (U.S.C.)

Within three months thereafter and on April 30, 1954, petitioners filed a petition for review of the decision of the Tax Court as provided by Sections 1141 and 1142 of the Internal Revenue Code. (Tr. pp. 104 to 108.) These two sections are believed to sustain the jurisdiction of this Court.

STATEMENT OF THE CASE.

Prior to the taxable year involved, taxpayer acquired certain real property in Sacramento County, California. A portion of such property had been subdivided and sold prior to August, 1946. Part of the property was included in the map of Hollywood Park Unit No. 2, hereinafter sometimes called Subdivision No. 2, which map was filed for record in the Office of the Recorder of Sacramento County on July 29, 1946. Another part of the property was included in the map of Hollywood Park Unit No. 3, hereinafter sometimes called Subdivision No. 3, which map was filed for record in the Office of the Recorder on November 25, 1947. (Tr. pp. 23-24.)

Taxpayer had individually engaged in the subdivision and sale of his Sacramento property. (Tr. p. 91.) During the summer of 1946, taxpayer had been advised by his counsel that, because of the undesirability of his having complete personal liability in connection with street contracts and sales of land, he should not engage in any further activity in his indi-

vidual capacity with relation to subdividing and selling his Sacramento real estate. (Tr. p. 91.)[3]

On August 28, 1946, Hollywood Subdivision, Inc. (hereinafter referred to as Subdivision), was incorporated under the laws of the State of California. Taxpayer's attorney and two of the attorney's employees were the incorporators. No capital stock was issued at that time. An application for a permit[4] to issue such stock in exchange for Subdivision No. 2 was filed with the Commissioner of Corporations of the State of California. This plan was subsequently abandoned when taxpayer became ill, was operated on, and went to Nevada to recuperate. (Tr. pp. 24, 91-2.)

Prior to the incorporation of Subdivision, taxpayer and his attorney did not discuss or consider the problem of whether or not taxpayer would ultimately sell the stock thereof. In addition to the undesirability of taxpayer's having complete personal liability in connection with street contracts or sales of land, taxpayer and his attorney looked into the question of income taxes, the effect thereof on taxpayer or the corporation or both jointly if instead of taxpayer engaging in the business personally, he had his corporation engage in the business of selling lots. (Tr. p. 92.)

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[3]These were among the business purposes for which Hollywood Subdivision, Inc. was incorporated.

[4]Erroneously described in the findings as a permit instead of an application for a permit.

Early in 1948, one Frank MacBride, Jr., who was in the real estate business in Sacramento, and who was the agent who had successfully sold the lots in Subdivision No. 2 that had been sold, approached taxpayer with regard to Subdivision No. 3. MacBride wished the right to sell the lots therein. He also offered to buy the lots. He was told by taxpayer's attorney, in the presence of taxpayer, that he could not buy the land; that the land was not for sale; and that he would not be permitted to be a real estate broker in the sale thereof. MacBride was informed by taxpayer's attorney, in the presence of taxpayer, that he *might* obtain control of the land by purchasing the stock of a corporation owning the land. The attorney further told MacBride that the *stock of the corporation was not for sale at that time;* that, if, after the stock was issued in exchange for the land, he was still interested in purchasing the stock, negotiations to that end could be instituted; but that, in the meantime, taxpayer could abandon his plan to transfer the land to the corporation in exchange for the stock, or MacBride could change his plan to submit an offer for the stock; and that the entire matter would have to be held in abeyance until the attorney's return from Washington. At this time, there was no effective permit from the California Commissioner of Corporations to issue the stock. Action to that end was instituted while the attorney was away but the application was not filed until after his return early in March, 1948. (Tr. pp. 92-3.)

On March 8, 1948, Hollywood Terrace, Inc. (hereinafter referred to as Terrace), was incorporated

under the laws of the State of California at the instance of Frank MacBride, Jr. Frank MacBride, Jr., Thomas J. MacBride and Dorothy M. Baker were the incorporators. At all times material to this proceeding, Frank MacBride, Jr., owned 98 per cent of all of its issued and outstanding common capital stock. Thomas J. MacBride owned one per cent thereof and Dorothy M. Baker owned one per cent thereof. At no time did taxpayer or his wife have any interest, direct or indirect, in the stock of Terrace. That corporation was at all times dominated and controlled by Frank MacBride, Jr. (Tr. pp. 25; 93.)

The permit to issue stock was granted to Subdivision by the Commissioner of Corporations of the State of California on March 29, 1948. On or about April 1, 1948, taxpayer exchanged Subdivision No. 3 for 1750 shares of $100 par value stock of Subdivision. Prior to the issuance of any of the stock of Subdivision, MacBride made an appraisal of the real estate. He valued it at $175,000. (Tr. pp. 93-4.)

On or about April 5, 1948, taxpayer's attorney arranged for the sale to Terrace of taxpayer's stock in Subdivision. At that time, taxpayer received a promissory note in the sum of $175,000 from Terrace, which corporation had little or no assets other than the stock of Subdivision, thereby acquired. Such stock was pledged by an instrument of pledge to taxpayer. It was reissued in the name of Terrace, and then was reissued in the name of taxpayer as pledgee. At that point taxpayer was the owner of a promissory

note having a fair market value when received in 1948 of $125,000, which note was secured by 1750 shares of the common stock of Subdivision. Subdivision continued to be the owner of the real estate, and Terrace was the owner of the 1750 shares, subject to the pledge to secure the promissory note. Thereafter and on April 6, 1948, MacBride, in writing, requested permission to alter the plans concerning the subdivision and to dissolve Subdivision. Such permission was granted by taxpayer and Subdivision was dissolved on or about April 8, 1948, by one or more or all of Frank MacBride, Jr., Thomas J. MacBride, and Dorothy M. Baker. At this point, taxpayer was the holder of the promissory note in the sum of $175,000, which note was secured by a deed of trust on Subdivision No. 3. (Tr. p. 94.)

Prior to April 5, 1948, Subdivision never had a bank account, it never paid any salaries to any employees, it never had any books of account, it never bought or sold any real estate or any personal property, and it had not entered into any business transactions of any kind. (Tr. pp. 94-5.)

The promissory note of Terrace, held by taxpayer, was liquidated in the years 1948 through 1951, as follows:

Year	*Payment*	
1948	$28,364.57	
1949	74,762.98	
1950	12,225.77	
1951	7,201.41	(Tr. p. 95)

On the Federal income tax return filed by taxpayer and his wife for the year 1948, they did not elect to report on the installment basis their gain on the sale. (Tr. p. 95.)

Giving full effect to the installment method of reporting, taxpayers' tax liability because of this transtion would be

Year	Payment	Profit		Tax Increase (decrease)	
1948	$28,364.57	$20,621.60	(Tr. p. 65)	$ 7,448.71*	(Tr. p. 66)
1949	74,762.98	54,352.70	(Tr. p. 68)	29,409.94	(Tr. p. 68)
1950	12,225.77	8,888.16	(Tr. p. 68)	4,144.45	(Tr. p. 68)
1951	7,201.41	5,452.50	(Tr. p. 69)	2,810.42	(Tr. p. 69)

*The 1948 figure would be a refund.

SPECIFICATION OF ERRORS.

A specification of the errors relied upon is as follows:

1. The failure to recognize that the transaction was in substance and fact as well as form a sale of corporate stock and not a sale of land.

2. The failure to recognize the business purpose of said corporation.

3. The finding that the conveyance of Subdivision No. 3 to Hollywood Subdivision, Inc.; the issuance of the stock of Hollywood Subdivision, Inc., to taxpayer S. Nicholas Jacobs; the transfer of such stock by said taxpayer to Hollywood Terrace, Inc., and the receipt by said taxpayer of a note in the sum of One Hundred Seventy-five Thousand and no/100 Dollars ($175,000.00) were component parts of a single trans-

action, by which taxpayer effected a sale of land in the ordinary course of business.

4. The finding that the corporation known as Hollywood Subdivision, Inc., served no business purpose and performed no business function other than to act as a conduit to transfer the title to Subdivision No. 3 from taxpayer to a purchaser of such real estate.

5. The finding of a deficiency in excess of that conceded by taxpayers for the calendar year 1948, in lieu of a determination that there was due and owing from taxpayers the sum of Two Thousand Twenty-five and 73/100 Dollars ($2025.73) and no more as and for a deficiency in income taxes for the calendar year 1948.

6. The finding and/or conclusion that taxpayers, not having reported the transaction on the installment basis in their return, are precluded from later adopting such method of reporting such gain.

SUMMARY OF ARGUMENT.

I. Taxpayers in substance and in fact sold corporate stock not land.

A. The common stock sold was a capital asset and the gain resulting therefrom a capital gain.

II. Hollywood Subdivision, Inc., did have a business purpose.

A. Business purpose not necessary to issue stock.

III. There was not a single transaction, there were three separate transactions.

A. The finding that there was a "Step Transaction" is not supported by the evidence.

IV. Taxpayers are entitled to report the gain on the installment basis.

V. Substance or form.

VI. Collapsible corporations.

THE ARGUMENT.

I. TAXPAYERS IN SUBSTANCE AND FACT SOLD CORPORATE STOCK NOT LAND.

The transaction by which taxpayer sold stock of Subdivision to Terrace was in substance and in fact a sale of a capital asset held for more than six (6) months, i.e., stock. The facts found by the Tax Court demonstrate that taxpayer sold stock in Subdivision to Terrace and not real property. Subdivision was

originally incorporated in 1946, at which time it was intended that Subdivision take over and develop other real property owned by taxpayer in the area. This intention was abandoned by reason of taxpayer's ensuing illness and the long period of recuperation necessitated thereby. The initial steps were taken in 1946 to complete the exchange then contemplated by filing an application[5] for a permit to issue stock with the Commissioner of Corporations of the State of California. These steps had to be and were abandoned because of taxpayer's illness. (Tr. pp. 91-2.) It is beyond controversy that in 1946 Subdivision had nothing to do with Subdivision No. 3, it was then considering only Subdivision No. 2. Subdivision then had business purposes to relieve taxpayer from personal liability whether in connection with contracts for the sale of land or contracts for improvement of streets or for sewers etc., or otherwise.[6] At this point there had been no transaction affecting taxpayer's income tax liability.

On or about April 1, 1948, taxpayer transferred Subdivision No. 3 to Subdivision in exchange for all of the stock of Subdivision. (Tr. pp. 55; 93-94.) This exchange was without gain or loss if taxpayer immediately after the exchange was in control of Subdivision.

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[5]The findings of the Tax Court incorrectly describe "an application for a permit" as "a permit". (Tr. p. 91.)

[6]Not infrequently a selling landowner is involved in fraud charges, not by reason of anything done by the landowner but because of alleged representations made by real estate salesmen.

Section 112(b)(5) provides:

> "(5) TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; * * *"

"Control" as used in the foregoing section is defined in Section 112(h)[7] as meaning the ownership of stock possessing at least 80% of the voting power plus 80% of any other shares of the corporation. In view of the fact that all of the stock of Subdivision is voting stock and was issued to taxpayer, he was in control "immediately after the exchange" unless his subsequent sale of the stock to Terrace five days later affected taxpayer's control immediately after the exchange.

A contract to sell and deliver stock in a corporation of a value of $500 or upwards is within the statute of frauds and is void unless some note or memorandum

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[7]Subdivision (h) of Section 112 reads as follows:

> "(h) DEFINITION OF CONTROL.—As used in this section the term 'control' means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."

in writing of the contract be signed by the party to be charged.

> *Meyer v. Child* (Sup. Ct. Calif., 1873), 47 Cal. 142 at p. 144;
> *Berkey v. Holm* (Cal. D.C.A., Second Dist., Div. 3, 1950), 101 Cal. App. (2d) 62 at p. 67 (headnote 2), 224 P. (2d) 885 at p. 889;
> 37 *C.J.S.* at p. 630 and cases cited in note 35;
> *California Civil Code,* Sections 1624, 1624a, 1724;
> *California Code of Civil Procedure,* Section 1973a.

These authorities make it abundantly clear that since there was no written agreement of sale or concerning the sale until April 5th, 1948, there was no sale or agreement of sale prior to April 5th. Moreover, under the California Corporate Securities Law (California Corporations Code Sections 25009, 26100, 26103) no contract concerning the security could be made until a permit from the Commissioner of Corporations was obtained to issue the stock.

The record makes plain that it was expressly planned and understood that there were to be no prospective commitments. Mr. MacBride "was told that there would be no program for a commitment that" taxpayer "could run out", that Mr. MacBride "could run out". (Tr. p. 52.)

A period of four or five days of control is adequate under Section 112(b)(5) and 112(h) even though a plan for ultimate disposal has been discussed.

American Bantam Car Co. v. Commissioner (1948), 177 F. (2d) 513; cert. denied (1949) 399 U.S. 920, 94 L. Ed. 1344, 70 S. Ct. 622, affirming 11 T.C. 397.

To the same effect see:

National Bellas Hess, Inc. v. Commissioner (1953), 20 T.C. 636, C.C.H. Dec. 19,758 at pp. 2779, 2785;

ACF-Brill Motors Company v. Commissioner (1950), 14 T.C. 263, 271-272;

G. & W. H. Carson, Inc. (1953), 12 T.C.M. 753, 756.

A. The common stock sold was a capital asset and the gain resulting therefrom a capital gain.

This common stock of Subdivision was a capital asset. "The term 'capital assets' includes all classes of property not specifically excluded by Section 117(a) (1)" (Section 29.117-1 of Regulation 111). Section 117(a)(1)[8] does not specifically exclude common

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[8](1) CAPITAL ASSETS.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer.

stock; therefore, the common stock of Subdivision sold by taxpayer to Terrace was a capital asset.

It must be admitted that Congress has determined that different tax consequences flow from (a) a sale of a capital asset than from (b) the sale of real estate which has been held primarily for sale to customers in the ordinary course of a trade or business.

Taxpayer refused to sell land. (Tr. p. 92.) He acquired stock in exchange for the land. (Tr. pp. 93-4.) At that time there was no deal or obligation for the sale of the stock. (Tr. pp. 92-3; 52-3.) Taxpayer then controlled the corporation. At that point taxpayer had no income tax liability for the sale or exchange of land. On or about April 5, 1948, taxpayer sold that stock to Terrace. He did *NOT* sell land. All he sold was the stock and if Subdivision had sold the land instead of being dissolved, no question could or would have been raised that it was not a sale of stock by taxpayer. Certainly at this point there is no income tax liability.

Subsequent to the purchase by Terrace, and completely independent of taxpayer, Subdivision was dissolved by Terrace, i.e., by the MacBride interests, not by taxpayer. (Tr. p. 94.)

Hence, the act that respondent apparently contends imposed the tax liability is something done by the MacBride interests. In other words, a tax liability is created because of something done after taxpayer sold his stock in Subdivision to Terrace. No case that we have found has imposed such a liability un-

less such action by the MacBride interests was a binding part of the original deal.

The decided cases demonstrate that the Commissioner and the Tax Court erred in making the ultimate finding (which should more properly be called a conclusion of law (see infra pp. 23-4) that taxpayer sold land instead of stock and in assessing a deficiency based on a sale of land.

In *U.S. v. Cumberland Public Service Co.* (1950), 338 U.S. 451, 94 L. Ed. 251, 70 S.Ct. 280, the corporation had been virtually forced out of business by TVA power. Others desired to purchase the corporation's assets, but the corporation, mindful from the beginning of the tax consequences, refused to sell its assets. The prospective purchasers of the assets were offered the stock of the corporation, but refused to buy stock. Finally, the shareholders dissolved the corporation, and sold the assets distributed to them pursuant to such dissolution. The Commissioner sought to charge the sale of assets to the corporation. In this attempt he failed, the Court of Claims holding that the sale was one by the shareholders, not the corporation. In affirming this determination, the Supreme Court said:

> "Respondent's shareholders, realizing that the corporation must get out of the power business unless it obtained TVA power, accordingly offered to sell all the corporate stock to the cooperative, which was receiving such power. The cooperative refused to buy the stock, but countered with an offer to buy from the corporation its transmission and distribution equipment. The

corporation rejected the offer because it would have been compelled to pay a heavy capital gains tax. At the same time the shareholders, desiring to save payment of the corporate capital gains tax, offered to acquire the transmission and distribution equipment and then sell to the cooperative. The cooperative accepted. The corporation transferred the transmission and distribution system to its shareholders in partial liquidation. The remaining assets were sold and the corporation dissolved. The shareholders then executed *the previously contemplated* sale to the cooperative.

* * * * * * *

"The Court of Claims found that the method by which the stockholders disposed of the properties was *avowedly chosen in order to reduce taxes,* but that the liquidation and dissolution genuinely ended the corporation's activities and existence. The court also found that at no time did the corporation plan to make the sale itself. Accordingly it found as a fact that the sale was made by the shareholders rather than the corporation, and entered judgment for respondent.

* * * * * * *

"Here the Court of Claims has found, on proper supporting evidence, that the sale in question was made by the stockholders rather than the corporation. The Government's argument that the shareholders acted as a mere 'conduit' for a sale by respondent corporation must fall before this finding. The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or

a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.

"The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern. For a corporation is taxed if it sells all its physical properties and distributes the cash proceeds as liquidating dividends, yet is not taxed if that property is distributed in kind and is then sold by the shareholders. In both instances the interest of the shareholders in the business has been transferred to the purchaser. Again, if these stockholders had succeeded in their original effort to sell all their stock, their interest would have been transferred to the purchasers just as effectively. Yet on such a transaction the corporation would have realized no taxable gain.

"*Congress having determined that different tax consequences shall flow from different methods* by which the shareholders of a closely held corporation may dispose of corporate property, *we accept its mandate.*"

The mandate of Congress is obvious in this case. Taxpayer, an individual, sold stock of a corporation and realized long term capital gain thereon. Taxpayer did not sell land; he expressly refused to sell land. (Tr. p. 92.)

The instant case is like that of *John R. Hopkins v. CIR* (1950), 15 T.C. 160, wherein taxpayer inherited an undivided one-fourth interest in certain real estate

from his father. The fair market value of the land at his father's death was $75,000.00 (taxpayer's one-fourth interest therefore being worth $18,750.00). In 1938 taxpayer formed the Arcadia Corporation to develop and sell the inherited real estate. He conveyed his undivided one-fourth interest to the corporation for 45 shares of its stock. 5 shares had previously been issued—three to taxpayer for cash, one to taxpayer's wife as a qualifying share, and one to taxpayer's attorney for services rendered. The corporation laid out the property into lots.

Taxpayer's sisters, the other co-owners of the property, originally planned to join taxpayer in the corporation in developing the property. The plans fell through and taxpayer's sisters sued for partition in 1939. A sale was ordered and taxpayer's sisters bid in the property at $42,500.00, paying in their three-fourths interest and $10,625.00 in cash. The corporation received $10,158.92 ($10,625.00 less expenses). The corporation was inactive thereafter and was dissolved in 1943 by the Governor of Florida for failure to pay its capital stock tax. Taxpayer claimed a loss on the liquidation of the corporation. The Commissioner disallowed the loss claiming that the corporate entity should be ignored and the sale treated as one directly from taxpayer to his sisters (and therefore disallowed under IRC Section 24(b)(1)(A)). If the corporate entity could not be ignored, taxpayer's loss would be allowed under IRC Section 24(b)(1)(B). HELD: Loss allowed. The Court said:

"While it is true that the corporation was wholly owned by the petitioner except for qualifying shares and that it never actually sold any lots, *it is equally manifest that a business purpose motivated its formation.* It has been repeatedly affirmed that a corporation is a taxpayer separate and distinct from its stockholders even where all of its stock is owned by one individual, and that its corporate entity may be disregarded only where it is shown to be a fiction or sham. Estate of L. B. Whitfield, 14 TC .... (No. 96, May 9, 1950) [Dec. 17634]; Moline Properties v. Commissioner, 319 US 436 [43-1 USTC Paragraph 9464]; National Carbide Corp. v. Commissioner, 336 US 442 [49-1 USTC Paragraph 9223]. There is nothing in the evidence to suggest that petitioner formed the corporation to accomplish the sale of the property to his sisters for the purpose of avoiding the ban of section 24(b)(1) on losses arising from intra-family sales."

The business motive underlying Subdivision was to relieve taxpayer of the burdens and risks attendant upon real estate development. He was and is a busy doctor who did not have the time or talent to devote to the proper development of the real property. Nor, because of the risks attendant thereto, could he afford, personally, to do the development. The practical solution was to create a corporation to take over the responsibilities and liabilities, leaving the doctor free to pursue his profession. This was done. True, its completion was delayed by matters beyond taxpayer's control. However, it was completed accord-

ing to the original plan and purpose. Ensuing events cannot change that fact. Further, the fact that the form adopted by taxpayer resulted in substantial savings to them taxwise is also insufficient to charge them with having created the corporation as a subterfuge to avoid taxes. As the Tax Court stated in *Paul Trousdale v. C.I.R.* (1951), 16 T.C. 1056, Dec. No. 18,280:

> "A taxpayer is entitled to 'decrease the amount of what otherwise would be his taxes or to altogether avoid them' by any bona fide means which the law permits (citing cases); and where the law is clear as to the tax consequences resulting from a particular course of action, such course of action will be given effect and governed by the clear provisions of the law, even though it was followed for the primary purpose of tax avoidance. (U.S. v. Cumberland Public Service, 338 U.S. 451.)"

II. HOLLYWOOD SUBDIVISION INC. DID HAVE A BUSINESS PURPOSE.

The Tax Court erred in finding that Hollywood Subdivision, Inc. had no business purpose. The cases cited by the Tax Court on ignoring the corporate entity have no application to this case. Not one of them deals with facts similar to those presented in this case. May we respectfully call the Court's attention to *John R. Hopkins* (1950), 15 T.C. 160, cited above.

Bond (1950), 14 T.C. 478, where the Court refused to disregard the corporate entity, citing and relying upon *Moline Properties, Inc. v. C.I.R.* (1943), 319

U.S. 436 to the effect that the corporate form should be disregarded only "where it is a sham or unreal. In such situations the form is a bold and mischievous fiction * * *"

Herbert v. Riddell (D.C. S.D. Cal. 1952), 103 F. Supp. 369, wherein the Court refused to disregard the corporate entity saying:

> "The Treasury Department is not * * * free to disregard the corporate entity where a tax benefit would result to the taxpayer. Conditions must exist which would warrant the conclusion that a particular organization served *no actual business purpose* * * *" (Emphasis the Court's.)

A. Business purpose not necessary to issue stock.

Conceding for the purposes of argument that no business purpose existed for the issuance of Subdivision's stock, whether the issuance was in furtherance of any corporate business purpose is immaterial to the decision of the case.

While it is well settled that a plan of corporate reorganization under Section 112 must have a business purpose or the tax-relieving provisions of that section will not operate,

(*Gregory v. Helvering* (1935), 293 U.S. 465.)

it is immaterial that no business purpose exist for the issuance of stock.

Chamberlin v. CIR (C.A. 6, 1953), 207 F. (2d) 462, at page 469, where the Court said:

> "Whether the declaration of the dividend was in furtherance of any corporate business purpose or

> was the result of correct judgment and proper business policy on the part of the management, we believe is immaterial on this phase of the case. The Supreme Court cases in no way suggest that the taxability of a stock dividend depends on the purpose of its issuance or the good or bad judgment of the directors in capitalizing earnings instead of distributing them."

III. THERE WAS NOT A SINGLE TRANSACTION; THERE WERE THREE SEPARATE TRANSACTIONS.

The Tax Court erred in holding that the transfer of land, the issuance of stock to taxpayers, the transfer of the stock to Hollywood Terrace, Inc., the dissolution of Subdivision and the receipt by taxpayers of a note in payment therefor were parts of a single transaction.

Under the heading of Findings of Fact the Tax Court said:

> "In addition, we make the following ultimate findings of fact:
>
> "The conveyance of Subdivision No. 3 to Hollywood Subdivision, Inc.; the issuance of the stock of Hollywood Subdivision, Inc. to petitioner; the transfer of such stock by petitioner to Hollywood Terrace, Inc., and the receipt by petitioner of a note in the sum of $175,000 were component parts of a single transaction, by which petitioner effected a sale of land in the ordinary course of business."

This is not a finding of fact, but is an erroneous conclusion of law. It is inconsistent with the spe-

cific finding that MacBride "was told by taxpayer's[9] attorney, in the presence of taxpayer, that MacBride could not buy the land; that the land was not for sale; and that MacBride would not be permitted to be a real estate broker in the sale thereof. MacBride was informed by taxpayer's attorney, in the presence of taxpayer, that MacBride might obtain control of the land by purchasing the stock of a corporation owning the land. The attorney further told MacBride that the stock of the corporation was not for sale at that time; that, if, *after* the stock was issued in exchange for the land, MacBride was still interested in purchasing the stock, negotiations to that end could be instituted; but that, in the meantime, taxpayer could abandon his plan to transfer the land to the corporation in exchange for the stock, or MacBride could change his plan to submit an offer for the stock; and that the entire matter would have to be held in abeyance until the attorney's return from Washington; at this time there was no effective permit from the California Commissioner of Corporations to issue the stock" of Subdivision. (Tr. pp. 92-3.)

Thus, in the so-called "ultimate finding of fact" the Tax Court finds taxpayer to be making a contract in violation of the California Corporate Securities Law. The Courts are bound to give the contract "such an interpretation as will make it lawful, operative, definite, reasonable, and capable of being carried into

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[9]In this quotation in the interest of clarity we have several times used the name MacBride instead of the pronoun "he" and have several times used the words "taxpayer" or "taxpayer's" instead of "petitioner" or "petitioner's".

effect, if it can be done without violating the intention of the parties". (*California Civil Code* Sec. 1643 and Sec. 3541; *California Code of Civil Procedure* Sec. 1963, subd. 19; *Robbins v. Pacific etc.* (Calif. Sup. Ct. in Bank 1937), 8 Cal. (2d) 241 at 273, 65 Pac. (2d) 42 at 58.) The so-called "ultimate finding" would put Mr. MacBride, taxpayer and the latter's counsel in the position of deliberately conspiring to violate the California Corporate Securities Law, whereas the specific finding of fact was "that, if after the stock was issued in exchange for the land, he [MacBride] was still interested in purchasing the stock, negotiations to that end could be instituted; but in the meantime taxpayer[10] could abandon his plan to transfer the land to the corporation in exchange for the stock, or MacBride could change his plan to submit an offer for the stock * * *" (Tr. pp. 92-3). Counsel for taxpayer was very pointed and meticulous to avoid a series of steps that could be treated as a single indivisible transaction. It is clear from the record as accepted by the Tax Court that either party could withdraw at pleasure.

Without the necessary factual predicates, the cases cited by the Tax Court in support of its holding are not applicable and cannot be used as authority in this case.

The Commissioner's and Tax Court's position in this case is closely analogous to that present in *Chamberlin v. Commissioner* (C.A. 6, 1953), 207 F. (2d) 462

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[10]We have here changed the word "petitioner" to "taxpayer".

(certiorari denied 347 U.S. 918, 98 L. Ed. 392, 74 S. Ct. 514). In that case the taxpayers were stockholders of Metal Moulding Corporation, which corporation had on hand large undistributed earnings. There was outstanding only common stock. The Articles of Incorporation were amended to authorize issuance of 4½% cumulative redeemable preferred stock. Two days after the amendment of the articles, the preferred stock was issued as a dividend to the common stockholders. Two days thereafter, *but as a result of prior negotiations,* all stockholders signed an agreement with the Northwestern Mutual Life Insurance Company and the Lincoln National Life Insurance Company, whereby the former would sell and the latter would buy all of the issued preferred stock (with a minor exception). Immediately after this sale, the insurance companies had the stock transferred on the books of the corporation. Taxpayers, the shareholders, reported the transaction as a stock dividend and the gain therefrom as long term capital gain. The Commissioner determined a deficiency on the ground that this was a dividend by the corporation taxable at ordinary rates. The Tax Court agreed with the Commissioner. However, the Court of Appeals for the Sixth Circuit reversed the Tax Court and held for the taxpayers. It was there held by the Circuit Court of Appeals that (1) the dividend was in substance as well as form a nontaxable dividend and (2) that the subsequent sale, although the result of prior negotiations, did not change its nature. The Court said (207 F. 2d at p. 468):

"In our opinion, the declaration and distribution of the preferred stock dividend, considered by itself, falls clearly within the principles established in Towne v. Eisner, supra, and Eisner v. Macomber, supra, and is controlled by the ruling in the Strassburger case. Accordingly, as a preliminary matter, we do not agree with the Tax Court's statement that the stock dividend is taxable because as a result of the dividend and immediate sale thereafter it substantially altered the common stockholders' pre-existing proportional interests in the Corporation's net assets. The sale to the insurance companies of course resulted in such a change, but the legal effect of the dividend with respect to rights in the corporate assets is determined at the time of its distribution, not by what the stockholders do with it after its receipt."

The facts in the instant case are parallel, i.e., land was transferred for stock, at which point there was no taxable transaction; thereafter the stock was sold. The taxability of the transaction should be determined at the time of the receipt of the stock, not what was done by the owner thereafter. That tax reduction may have been the purpose is not determinative of the issue. As the Court states in the *Chamberlin* case (207 F. 2d at pp. 471-472):

"Each case necessarily depends upon its own facts. The facts in this case show tax avoidance, and it is so conceded by petitioner. But they also show a series of legal transactions, no one of which is fictitious or so lacking in substance as to be anything different from what it purports to be.

> Unless we are to adopt the broad policy of holding taxable any series of transactions, the purpose and result of which is the avoidance of taxes which would otherwise accrue if handled in a different way, regardless of the legality and realities of the component parts, the tax assessed by the Commissioner was successfully avoided in the present case. We do not construe the controlling decisions as having adopted that view."

A. Finding that there was a step transaction is not supported by the evidence.

The finding (which is in reality an erroneous conclusion of law from the facts found) that

> "The conveyance of Subdivision No. 3 to Hollywood Subdivision, Inc.; the issuance of the stock of Hollywood Subdivision, Inc., to petitioner; the transfer of such stock by petitioner to Hollywood Terrace, Inc., and the receipt by petitioner of a note in the sum of $175,000 were component parts of a single transaction, by which petitioner effected a sale of land in the ordinary course of business." (Tr. p. 95.)

is not supported by the evidence.

The evidence shows that these steps were taken independently.

1. Subdivision was incorporated in 1946. Because of taxpayer's illness which necessitated his leaving the state, no stock was issued at this time. (Tr. pp. 45, 48-50.)

2. Early in 1948, an offer by MacBride to buy the land was rejected by taxpayer's attorney in his pres-

ence. (Tr. pp. 50-1.) At that time MacBride was told that taxpayer intended to convey the land to Subdivision in exchange for its stock (Tr. pp. 50-54), and that if he, MacBride, were still interested after the corporation obtained a permit from the Commissioner of Corporations of the State of California and after the stock was issued pursuant thereto, negotiations for the purchase thereof could be made. (Tr. pp. 50-54.)

3. The permit to issue stock was issued to Subdivision on March 29, 1948. (Tr. p. 55.) The stock was issued to taxpayer pursuant thereto not later than April 2, 1948. (Tr. p. 55.) At this time there was no commitment of any kind to sell the stock.

4. The stock was sold to Terrace April 5, 1948, pursuant to negotiations had by Everett S. Layman. (Tr. p. 57.)

5. Subdivision was dissolved by the MacBride interests on or after April 8, 1948. (Tr. p. 85.) Taxpayer had no part in this dissolution.

IV. TAXPAYERS ARE ENTITLED TO REPORT THE GAIN ON THE INSTALLMENT BASIS.

The Tax Court erred in holding that taxpayer having elected to report the income herein involved on a cash basis may not now change to report it on the installment basis. However, as we will now demonstrate, if the substance of the sale was that of land, it is equally true that it was in substance an install-

ment sale and to fail to so regard the transaction would be unrealistic and would distort taxpayer's income for the year 1948.

During the tax year 1948, taxpayer received on account of said note the sum of $28,364.37, or less than 30% of the fair market value of said note. (Tr. p. 65.) The following figures show the amounts paid, the profit resulting in each, and the refund and/or additional taxes which would result in the exercise of the election for the years 1948-1951 in liquidation of the note held by taxpayer which it was stipulated had a fair market value of $125,000.00:

Year	Payments	Profit	Additional Taxes	
1948	$28,364.57	$20,621.06	$ 7,448.71[11]	(Tr. p. 66)
1949	74,762.98	54,352.70	29,409.94	(Tr. p. 68)
1950	12,225.77	8,888.16	4,144.45	(Tr. p. 68)
1951	7,201.41	5,452.50	2,810.42	(Tr. p. 69)

Using $125,000.00 as the fair market value, the note was liquidated as follows:

1948	22.69%
1949	59.81%
1950	9.78%
1951	5.76%

If we should look at substance, we should look at it all the way through. If we disregard the stock, we should disregard the note. We should treat the transaction as a sale on the installment basis. If stock is to be disregarded and treated as land because of form and substance, taxpayer's asserted deficiency should

[11]The 1948 tax figure would be a refund.

be reduced by a figure in excess of $12,450.00 treating the transaction as an installment sale. There is no legal justification for treating half the transaction as form and the other half as substance.

This would be the liability on an installment basis:

Year	Refund	Additional Taxes	
1948	$7,448.71		(Tr. p. 66)
1949		$29,409.94	(Tr. p. 68)
1950		4,144.45	(Tr. p. 68)
1951		2,810.42	(Tr. p. 69)

Election implies an intentional choice. This, the taxpayer did not have when he filed his return, he then believing the transaction to be a capital gain. Taxpayer is now entitled to make that choice if the transaction is held to be a sale of land and not a sale of stock.

See *Scales v. Commissioner* (6th Cir. 1954), 211 F. 2d 133. In the *Scales* case taxpayer sold a dairy farm on a lease-sale form of contract. He reported payments made as rent. This was disallowed and a gain on the whole transaction was asserted in the year of sale. Taxpayer argued that he at least should be allowed the benefits of reporting on the installment sale basis. The Tax Court held for the Collector of Internal Revenue on the ground that the taxpayer had not elected to report the sale on the installment basis on his return. On appeal, the Court held for taxpayer:

> "We think that, upon the authority of our decision in United States v. Eversman, 133 Fed. (2d) 261 (C.A. 6) [43-1 USTC Par. 9284], the court erred. In that case, we held that the tax-

payer was entitled to the benefit of section 44(b) of the Internal Revenue Code upon facts which, in principle, are not to be distinguished from those of the instant case. In the Eversman case, we said [133 Fed. (2d) 266] that the failure of the taxpayer 'to adopt fruitless ritualistic measures' should not foreclose the allowance to her of all lawful benefits to which she was entitled under the statute. We stated that we found no force in the argument that Mrs. Eversman was required to make an express election in her income tax return in order to receive the benefits available to her under sections 44(b)[12] and 44(d)[12] of the statute."

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[12]"(b) SALES OF REALTY AND CASUAL SALES OF PERSONALITY [sic].—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term 'initial payments' means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * * * * *

"(d) GAIN OR LOSS UPON DISPOSITION OF INSTALLMENT OBLIGATIONS.—If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. Any gain or loss so resulting

In *United States v. Eversman,* 133 F. (2d) 261 (C.A. 6, 1943) 43-1 U.S.T.C. Par. 9284, the action was for a refund. There an installment sale had terminated in the same year and the buyers returned the property and were discharged from the contract. Money received by the taxpayer was not reported as income since a loss was realized on the whole transaction. The transaction was, however, reported on the return. The Collector of Internal Revenue assessed a deficiency which was paid and this action commenced. One ground relied on by the C.I.R. was that no express election had been made to report on the installment basis. The Court held for the taxpayer, saying:

> "We find no force in the argument that Mrs. Eversman was required to make an express election in her tax return, in order to receive the benefits available to her under Sections 44(b) and 44(d) of the statute. The Government would

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shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full. This subsection shall not apply to the transmission at death of installment obligations if there is filed with the Commissioner, at such time as he may by regulation prescribe, a bond in such amount and with such sureties as he may deem necessary, conditioned upon the return as income, by the person receiving any payment on such obligations, of the same proportion of such payment as would be returnable as income by the decedent if he had lived and had received such payment. If an installment obligation is distributed by one corporation to another corporation in the course of a liquidation, and under section 112(b)(6) no gain or loss with respect to the receipt of such obligation is recognized in the case of the recipient corporation, then no gain or loss with respect to the distribution of such obligation shall be recognized in the case of the distributing corporation."

have us read into the statute requirements not found there. No provision to the effect that the taxpayer must have made an express election in a previous taxable year is found in the statute. While Mrs. Eversman, in her 1931 income tax return, did not expressly state her election to report under Section 44(b) the $20,000 received from the property sale during that year, she did file, with her return, a detailed report of the sale and repossession of the Wagner property. The course pursued by her evidenced a manifest belief that the transaction which she had described entailed no additional tax liability. The Treasury Department was put in possession of all the relevant facts. Her failure to adopt fruitless ritualistic measures should not foreclose the allowance to her of all lawful benefits under the statute."

Also see:

Key Largo Shore Properties (1930), 21 BTA 1008;

Ives Dairy (1931), 23 BTA 529.

Reality and the decided cases compel the conclusion that if the transaction in question was in substance a sale of land, it was an installment sale of that land and taxpayers are entitled to so treat it. However, we reiterate our position that the transaction was in substance as well as form a sale of stock, as the following argument will further demonstrate.

V. SUBSTANCE OR FORM.

It must be admitted that Congress has determined that different tax consequences flow from (a) a sale of a capital asset than from (b) the sale of real estate which has been held primarily for sale to customers in the ordinary course of a trade or business.

Taxpayer refused to sell land. He acquired stock in exchange for the land. At that time there was no deal or obligation for the sale of the stock. Taxpayer then controlled the corporation. Thereafter, he sold the stock. He did NOT sell the land. At that point taxpayer had no income tax liability for the sale of land. All he had sold was the stock. Taxpayer paid a capital gains tax on the transaction of $21,576.66. Respondent seeks to increase that amount by $41,-370.43, treating the gain as ordinary income.

Subsequent to the purchase by Terrace and completely independent of taxpayer, Subdivision was dissolved by Terrace, i.e. by the MacBride interests, not by taxpayer.

Hence, the act that respondent apparently contends imposed the tax liability is something done by the MacBride interests. In other words, a tax liability is created because of something done after taxpayer sold his stock.

We are not sure we understand that which is substance and that which is form. The Supreme Court in the *Cumberland* case supra, pp. 16-18, speaking of the *Court Holding Company* case (1944, 324 U.S. 331, 65 Sup. Ct. 707, 45-1 U.S.T.C. par. 9215) says:

"* * * 'The incidence of taxation depends upon the substance of a transaction' regardless of 'mere formalisms', and that taxes on a corporate sale cannot be avoided by using the shareholders as a 'conduit through which to pass title.' "

The only factual difference we can see in those two cases is that in the *Court Holding Company* case the deal started out as a sale of assets by the corporation and ended as a sale of assets by individuals; in the *Cumberland* case the corporation refused to make a sale of its assets and after such refusal the sale started and ended as a sale of assets by individuals. Here, taxpayer refused to sell the land and after such refusal the sale started and ended as a sale of stock. It was the purchaser who dissolved Subdivision, NOT taxpayer.

To say that an application to the California Commissioner of Corporations, the deeding of the property to Subdivision and the issuance of stock in exchange therefor is form and not substance, stretches our credulity. At that point Subdivision owned the land and taxpayer owned the stock, and he had no commitment from any one to buy any land or any stock. That isn't form; that is substance.

Taxpayer then sells stock and not land. That isn't form; that is substance.

What the purchaser does after that point is no concern of taxpayer; it can't affect his situation any more than did the sale of the preferred stock issued as a dividend affect the stock dividend involved in the *Chamberlin* case (supra p. 22).

Whether a contract is or is not within the statute of frauds is a matter of substance rather than of form.

Whether a contract violates the California Corporate Securities Law is a matter of substance rather than of form.

In California there can be no deficiency judgment on a sale of real estate. (California Code of Civil Procedure, Section 580(b).) That is not true on a sale of corporate stock.[13] Whether a deficiency is obtainable is a matter of substance not form.

VI. COLLAPSIBLE CORPORATIONS.

Both the House Committee Report (House Ways & Means Committee Report June 23rd, 1950—81st Congress, 2d Session, Report No. 2319) and the Senate Committee Report (Senate Finance Committee Report—August 22, 1950, 81st Congress, 2nd Session, Report No. 2375) contain the following:

> "The collapsible corporation is a device which has been used in an attempt to convert ordinary income into long-term capital gain by use of a temporary corporation. The device has been used * * * in the building-construction trade by contractors who have corporations construct buildings for sale and then liquidate the corporations and sell the buildings as individuals.

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[13] It is apparent that Terrace was brought into being because Mr. MacBride didn't want personal liability.

> "Under section [213] of your committee's bill the gain realized from the sale or exchange (including liquidation) of stock in a collapsible corporation will be treated as ordinary income for tax purposes, in the case of a stockholder owning 10 percent or more of the corporation's stock, if the gain realized from the sale or exchange of the stock during the year is more than 70 percent attributable to property produced by the corporation, * * *
>
> "It is estimated that the closing of the *collapsible-corporation loophole* will produce approximately $3 million additional revenue annually."

Both reports state they are closing a loophole. That can mean only one thing—certain types of long-term capital gains permitted to be taxed at long-term capital gain rates under the existing law would under the new law be taxed at ordinary income rates. Closing this loophole will produce approximately $3,000,000 additional revenue each year only if by the change in the law, i.e., a change in the rates, that much more in taxes would be produced. Hence, it is clear that a change in the law was intended. If the new law would increase the taxes it can only mean that under the prior law such income was taxable only at long-term capital gain rates. That is our position here. Both committees said there was a loophole, i.e., that the type of income which they thought should be taxed as ordinary income was under the then existing law taxed as long-term capital gains.

Having thus recognized a loophole, Congress plugged it—but only in part. Without attempting to go into section 117(m) in detail, it is clear (117(m)-3-B) that it does "NOT apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so * * * constructed." Little, if any (and certainly not 70%) of the profit here came from any construction work. Hence the section would not apply to the facts of this case. This makes it evident that Congress had no intention of plugging any asserted loophole where less than 70% of the profit came from construction. There are other provisions which we could discuss showing that 117(m) was not intended to apply to facts such as we have here.

It is true, of course, that Section 117(m) does not apply to gain realized in 1948. However, if the transaction is to be ignored and treated as a sale of land there would seem no reason not also to ignore the note and treat a portion of each payment received as income. If that be done the section would apply to the profit realized in 1950 and 1951, if the section is applicable to the transactions here involved.

There is only one logical conclusion if in 1948 the type of transaction is taxable at ordinary rates and in 1950 and 1951 the transaction is taxable at capital gain rates, then the change in the law did NOT CLOSE a loophole; it opened a loophole where none existed before. It not only did not increase the revenues, it effectively and affirmatively decreased the

revenues. It is obvious therefore that prior to 1950 such transactions were not taxed as ordinary income because they were long-term capital gains. Since the 1950 Revenue Law certain long-term capital gains are taxed at ordinary rates because the law says so.

CONCLUSION.

Will you sell me your land? No; I will not sell you my land.

What will you do? I may exchange my land for stock of a corporation.

Will you sell me that stock? No, but after the stock is issued pursuant to a permit from California's Commissioner of Corporations I will then negotiate with you for the sale of the stock.

Won't you now agree to sell me the stock after it is issued? No, for two reasons, first, I would violate the California Corporate Securities Law, and second, I would no longer be in control of the corporation within the meaning of 112(b)(5). Both reasons to me are reasons of substance and not of form.

Isn't the sale of the stock in substance the same as the sale of the land? No. The two things are quite different. If I sold you the land I couldn't get a deficiency judgment. When I sell you the stock I can

get a deficiency judgment. That to me is a matter of substance; not form.

Dated, San Francisco, California,
August 30, 1954.

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